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No. 536

In the

# Supreme Court of the United States

OCTOBER TERM, 1968

JOSEPH REITER and
LEROY GUNTNER, Co-trustees,

*Petitioners,*

*vs.*

FEDERAL SAVINGS AND LOAN
INSURANCE CORPORATION,

*Respondent.*

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Petitioners herein, co-trustees, Joseph Reiter and Leroy Guntner, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit rendered on June 7, 1968.

## OPINIONS BELOW

The opinion and judgment of the United States District Court for the Northern District of Illinois awarding the funds in controversy to petitioners is unreported and is set forth in *Appendix,* p. 1a.

The opinion of the United States Court of Appeals for the Seventh Circuit, reversing the trial court without remand, is set forth in *Appendix,* p. 9a, and is reported at 396 F. 2d 407.

## JURISDICTION

The jurisdiction of this Court is invoked under 28 U.S.C. §1254 (1). The judgment of the United States Court of Appeals for the Seventh Circuit was entered on June 7, 1968. The timely filed petition for rehearing was denied on July 2, 1968.

## QUESTIONS PRESENTED

1. Whether the Federal Home Loan Bank Board exceeded its authority in compelling depositors of a Federal Savings and Loan Association to sign an Agreement using their deposits as a guarantee against future losses as a condition for issuance of a federal charter.
2. Whether the Federal Savings and Loan Insurance Corporation may withhold insurance benefits from depositors who have not waived their rights under the National Housing Act.

## STATUTES INVOLVED

The statutory provisions involved in this case are 12 U.S.C.A. 1728 (b) and 12 U.S.C.A. 1464(a). They are set forth in full in *Appendix,* p. 19a. Also involved is 12 C.F.R. Ch. V(c), §543.2, Rules and Regulations of the Federal Savings and Loan System (set forth also in *Appendix,* p. 20a.

## STATEMENT OF THE CASE

Joseph Reiter and LeRoy Guntner, co-trustees, plaintiffs and appellees, filed a complaint for a declaratory judgment against Federal Savings and Loan Insurance Corporation, a corporate instrumentality of the United States. Plaintiffs asked the District Court to adjudicate the rights of the parties in an account or deposit originally of $55,557.26 at Merchandise National Bank of Chicago and now of $50,000.00 at National Boulevard Bank of Chicago.[1] (App. 4, 94)

The District Court sustained a motion for summary judgment filed by plaintiffs and overruled a similar motion by defendant. It declared plaintiffs to be the owners of the account or deposit in controversy and defendant to be without any interest therein. (App. 90) This appeal followed.

This case presents only questions of law raised on the uncontroverted following facts. First Federal Savings and Loan Association of Morton Grove (First Federal) was chartered on August 1, 1959, by the Federal Home Loan Bank Board (the Board). (App. 12). The Board is the agency of the United States charged with the responsibility of chartering and regulating federal savings and loan associations. The Board prescribed as a condition for the issuance of that charter the "pledge" of savings

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[1] Throughout the record before the Court there are references to these two figures. The $50,000.00 represents the original amount of certain savings share accounts pledged by plaintiffs and the $55,557.26 represents the same accounts augmented by dividends or interest which were credited thereto. A discussion of the case sometimes requires a reference to the $55,557.26 figure, but the parties have agreed that only the $50,000.00 is in controversy.

share accounts of First Federal in the amount of $50,000.00 as a guaranty by the pledgors to First Federal against future losses. (App. 62) The Federal Savings and Loan Insurance Corporation has the same management as the Board but is a separate corporation.

The terms of the pledge were incorporated in the "Pledge and Escrow Agreement". (App. 62) This Agreement was to remain in effect for five years beginning on August 1, 1959, the date of the issuance of the charter to First Federal. (App. 64) The Agreement provided that whenever the Board found an impairment in the capital of First Federal or any deficit in any accounting period, the Board might direct the Federal Home Loan Bank of Chicago to deliver the pledged share accounts to First Federal for cancellation and for transfer of the dollar amounts thereof to First Federal's reserves for the purpose of absorbing losses. (App. 64) It further provided that if any charges against the pledged share accounts had been made, a refund thereof should be forthcoming, after the termination of the Agreement on August 1, 1964, provided such refund would not reduce the net reserves of First Federal to less than three per cent of its net assets. (App. 64) It provided that the pledged share accounts might be delivered for similar cancellation and transfer on liquidation of First Federal. (App. 64). The exact language of the Pledge and Escrow Agreement is as follows: (App. 63)

> "Now, Therefore, • • • the undersigned do hereby assign and deliver as of the date hereinabove first written the shares of said First Federal Savings and Loan Association of Morton Grove, as hereinafter described in the amounts stated as shown opposite their respective names in the total amount of $50,000, in escrow to the Federal Home Loan Bank of Chicago,

to be held by it as a pledge and guaranty to First Federal Savings and Loan Association of Morton Grove against operating deficits and losses of any and all kinds which exceed other reserves; this pledge and agreement to remain in full force and effect for a period of five years beginning August 1, 1959; provided that after the expiration of the first three years of the term of this agreement, the release of said pledge and escrow, in whole or in part, may be authorized by the Federal Home Loan Bank Board whenever the net reserves established for the purpose of absorbing losses and surplus of the association together equal at least 3% of its net assets.

"It is agreed that, whenever the Federal Home Loan Bank Board finds that any impairment in the capital of the association or any deficit in any accounting period exists after the payment of all expenses incurred, provision for dividends and proper allocations to reserves and surplus, the said Board is authorized from time to time in its discretion, to direct the Federal Home Loan Bank of Chicago to deliver the shares herein pledged or any portion thereof, pro rata to the amount to the credit of the undersigned, to said association for cancellation and simultaneous transfer upon its books of the dollar amount of credits represented by such cancelled shares to the reserves of said association for the purpose of absorbing such losses or operating deficits. Such shares may likewise be delivered for cancellation in the manner and for the purposes hereinabove provided, in the event of the liquidation of the said association.

"If during the life of this agreement there shall have been any charges against the share accounts herein pledged, the said association shall, whenever possible after the termination of this agreement, refund such amounts on a pro rata basis to the pledgors; provided, however, that no refund to any pledgor shall exceed the amount such pledgor has

been required to forfeit by reason of the terms of this agreement; and provided, further, that no such refund shall be made when the said association's net reserves for losses and surplus would thereby be reduced to less than 3% of its net assets.

"The aforesaid Board may from time to time release all or part of the shares of any of the pledgors, provided that shares of the association, in an amount at least equal to the shares released, shall be substituted by a pledgor or pledgors who shall agree to be bound by the terms of this agreement, without any further consent or agreement of other pledgors, the undersigned or any of them."

The document called "Pledge and Escrow agreement" was signed by 17 depositors. Although the Federal Home Loan Bank Board was a party it did not sign the document (App. 65). Only 7 depositors were later directors or officers of First Federal (App. 69, 70). The record is clear that approximately ten depositors were in no way connected with the promotion, organization, or management of First Federal (App. 65, 69, 70). The funds were kept in twelve different accounts (App. 65-67). Two of the original depositors were allowed to withdraw their funds and substitute deposits were made to bring the total to $50,000.00 (App. 66, 67).

Until the early part of 1964, the manager of First Federal was Richard Brooker who is not a party here. (App. 68). The question of losses was not in issue in the trial court, nor should it be an issue on appeal. It can be assumed, for the sake of disposition of this case that there were losses in excess of $50,000.00. It should be noted, however, that although First Federal did not anticipate that it would be able to meet its dividend as of June 30, 1964, the record indicates only *potential*

losses and not *actual* losses during the life of the agreement in question. (App. 68). The fact that mortgage loans are *delinquent* does not establish the *fact* of losses before August 1, 1964 when the agreement terminated.

The depositors in this case did not benefit financially from First Federal, but on the contrary, suffered losses as the result of their attempts to establish a Savings & Loan in their community. (App. 69).

The Directors of First Federal under date of May 4, 1964, sent a letter to the Federal Home Loan Bank of Chicago in which they stated that First Federal would be deficient $47,000.00 of the amount necessary to pay a current dividend on savings accounts. (App. 68). They sought the Board's permission to use escrow funds to meet current dividend requirements. They also asked the Board to require the Insurance Corporation to make a sufficient contribution to absorb all potential losses in the Sleepy Hollow Subdivision. (App. 68).

Although First Federal anticipated difficulty in meeting its June 30, 1964 dividend it submitted a merger proposal to the Federal Home Loan Bank Board which would have solved its problems and avoided the necessity of a forfeiture of the $50,000. (App. 32, 71, 68, 73). Offers of capital and absorption of potential losses including meeting of the June 30, 1964 dividend were made by various groups shortly before the merger of First Federal and Second Federal. (App. 68).

On June 8, 1964, at the request of the Board, the Directors of First Federal signed a written consent to the future appointment of a conservator or receiver for First Federal if and when the Board deemed it necessary. (App. 31). On June 15, 1964, the Board rejected various proposals submitted by the directors of First Federal.

(App. 73). On the same day the Board adopted a resolution appointing a conservator who should take charge of First Federal at the close of business on June 27, 1964. (App. 76). First Federal was not notified of this decision until June 27, 1964.

However, on June 18, 1964, the directors of First Federal held a special meeting. At that meeting, they voted to transfer $55,557.26, the balances of the pledged share accounts, to Reiter and Guntner, co-trustees, pending final determination of the status of the accounts to be held for the benefit of all the depositors. (App. 32).

The minutes of the June 18, 1964 meeting of the Board of Directors of First Federal, reflect the clear intent to make an absolute transfer of the funds in each of the deposit accounts to the depositors themselves, by means of trustees for their benefit (Pl. Ex. 26, App. 32):

> WHEREAS the directorate of this Association has submitted two separate proposals to the Federal Home Loan Bank Board for approval, either of which would have represented a practical and final solution to the Association's problems, and
>
> WHEREAS, the Federal Home Loan Bank Board has rejected each proposal, with the expressed intention to levy against certain pledged savings accounts of the Association;
>
> NOW THEREFORE, BE IT RESOLVED: That the directorate hereby directs that the funds represented by said pledged accounts in the amount of $55,557.26 be disbursed by the Association to Joseph Reiter and Leroy Guntner as co-trustees for the pledgors, to hold said funds in escrow pending final determination of the status of the accounts. (App. 32).

Pursuant to this resolution, Joseph Reiter withdrew $50,000.00 from First Federal and deposited the same in

an account in the names of himself and Guntner, co-trustees, in Merchandise National Bank of Chicago. (App. 81). On June 20, 1964, Giese, another pledgor and director, withdrew $5,557.26 and deposited it in the same names. (App. 82). Later, the funds were transferred to National Boulevard Bank of Chicago. (App. 94). The rights of the respective parties in the specific account or deposit of $50,000.00 in National Boulevard are what are in issue before this Court. The matter of the sum of $5,557.26 is not involved, the defendant having conceded that plaintiffs were entitled to it.

It is to be noted at this point that under the 1959 Agreement the Federal Home Loan Bank was given possession of the passbooks to the deposit accounts. However, First Federal itself retained actual possession of the funds until the June 18, 1964 transfer. (App. 64).

On June 22, 1964, subsequent to the transfer of funds by the Directors, the Board found that an impairment in capital of First Federal existed. Pursuant to the provisions of the Pledge and Escrow Agreement, it directed the Federal Home Loan Bank of Chicago to deliver the pledged share accounts to First Federal for cancellation and for transfer of the dollar amounts thereof to its reserves for the purpose of absorbing losses. (App. 33, 34). The conservator took charge of First Federal at the close of business on June 27, 1964. On June 27, 1964, a "Sale and Purchase Agreement" was entered into between the conservator, on behalf of First Federal, and the Insurance Corporation. (App. 41). The purpose of this Agreement was to facilitate a merger of First Federal into Second Federal Savings and Loan Association of

Chicago (Second Federal), an established institution. (App. 41). This Agreement required the Insurance Corporation to purchase an enumerated list of assets of First Federal consisting of mortgage loans (App. 42, 79) and also obligated it to purchase additional such assets of $1,000,000.00 during the following six months, which assets would be selected by the association. (App. 43). The Insurance Corporation further assumed all undisclosed facilities of First Federal. (App. 44).

The Merger Agreement between First Federal and Second Federal became effective on June 27, 1964. (App. 36, 77). The Merger Agreement provided that First Federal shall be merged with and become part of Second Federal, which shall be the resulting association. (App. 36). The existing charter of Second Federal was made the charter of the resulting association. (App. 37). The Merger Agreement set forth that the resulting association shall be deemed to be, and shall be, a continuation of the identity of Second Federal. (App. 37). By the Merger Agreement all assets of First Federal, expressly including the benefits arising under the Sale and Purchase Agreement, were vested in Second Federal and all savings share accounts of First Federal were transferred to Second Federal. (App. 38, 39). The Merger Agreement also provided that "all liabilities of First Federal * * * shall be assumed by the resulting association and may be enforced against it to the same extent as if such liabilities had been incurred or contracted by it." (App. 39). The Sale and Purchase Agreement was incorporated by reference in the Merger Agreement. (App. 39).

On July 16, 1964, the Insurance Corporation obtained from Second Federal an assignment of its claim by reason of the withdrawals of $55,557.26 and the deposits thereof with Merchandise National. (App. 47). It paid Second Federal the sum of $55,557.26 therefor. (App. 49).

The District Court granted plaintiffs' motion for summary judgment holding that under the terms of the Pledge and Escrow Agreement, plaintiffs had a right of reimbursement from First Federal in the amount of $50,000.00 after the termination date of the Agreement on August 1, 1964, provided such refund would not reduce the net reserves of First Federal below three per cent of its net assets. The District Court also held that under its construction of the Merger Agreement, Second Federal assumed that liability and became obligated to make the refund in view of Second Federal's financial position. The Court further held that the Insurance Corporation was subject to the same obligation, since it had no greater rights than Second Federal, its assignor. The District Court concluded that whatever the Insurance Corporation's right to the account or deposit of $50,000.00, it was limited by, and subject to, plaintiffs' claim of reimbursement. Thus the Court declared plaintiffs to be the owners of the account or deposit in controversy and the Insurance Corporation to be without any interest therein. (App. 90-99).

On appeal the Seventh Circuit reversed, with directions, granting defendant's motion for summary judgment from which this petition for writ of certiorari is taken by plaintiffs.

## REASONS FOR GRANT OF WRIT

### 1. The claim of the Federal Savings and Loan Insurance Corporation is based upon an illegal agreement.

This controversy has its origin in the questionable practice of the Federal Home Loan Bank (hereafter called "the Board") requiring a guarantee against future losses before issuing a Federal Savings and Loan Charter. In 1959 the Board required execution of a document entitled "Pledge and Escrow Agreement" by certain organizers planning a savings and loan association in Morton Grove, Illinois. (App. 28, 62). In addition, other persons not connected with the organization or management of the planned association also signed. Together they did deposit the sum of $50,000 in 1959 in First Federal Savings and Loan Association of Morton Grove (hereafter First Federal) in twelve regular deposit accounts insured by the Federal Savings and Loan Insurance Corporation. (App. 65).

When First Federal experienced financial difficulties over four years later the Board on June 22, 1964 ordered the $50,000 in deposits to be forfeited under the terms of the "Pledge and Escrow Agreement" to absorb losses. The depositors of the $50,000 *already* had received the $50,000 by transfer from First Federal on June 18, 1964. The Federal Savings and Loan Insurance Corporation (hereafter called the "insurance corporation") was assigned the claim to the $50,000, denied the transfer was effective, and asserted that the Directors illegally transferred $50,000 in *general* funds of First Federal basing its claim on the obligations of the "Pledge and Escrow Agreement."

It is petitioner's position that the "agreement" required by the Board was illegal in that it was beyond

the authority granted the Board in the statutory enabling provisions and in violation of the Board's own rules.

It is not disputed that Congress has not granted the Federal Home Loan Bank Board the *specific* statutory power to require guarantees as a condition precedent in the issuance of a federal savings and loan charter. The question is whether the exercise of such power is authorized by the language of §1726(b) of the National Housing Act (12 USC §1726(b)) requiring insured institutions to provide adequate reserves or 12 USC §1464(a) giving the Board the power to make necessary regulations. The Court of Appeals held that the Board's action was authorized by the language of Sections 1726(b) and 1464(a), 12 USC. It stated in the following language:

> "Plaintiffs finally argue that their pledges were invalid as beyond the authority of the Loan Bank. Section 1726(b) of the National Housing Act (12 USC §1726(b) required insured institutions to provide adequate reserves. Consistently therewith, the regulations, which are a permissible exercise of the power conferred on the Loan Bank by Section 5(a) of the Home Owners Loan Act (12 USC §1464(a)) permit the Loan Bank to prescribe whatever 'requirements as it deems necessary or desirable' (12 CFR §543.2(d)). These provisions empowered the Loan Bank to exact the $50,000 pledged as a guaranty against losses." (Appendix, p. 17a, 396 F. 2d 411).

A review of the provisions of the statute and rule referred to by the Court of Appeals will help clarify the issues. Section 5(a) of the Home Owners Loan Act (12 USC §1464(a)) provides as follows:

> "In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, in-

> corporation, examination, operation, and regulation of associations to be known as 'Federal Savings and Loan Associations,' and to issue charters therefor, giving primary consideration to the best practices of local mutual thrift and home-financing institutions in the United States.'

It is clear that the above general enabling statute does not specifically authorize the Board to exact any type of guarantee as a condition for issuance of a federal savings and loan charter. It merely authorizes the Board "to provide for the organization, incorporation, etc." of federal savings and loans "under such rules and regulations as it may prescribe."

Pursuant to this authority, the Board enacted the following rule:

> "If the Board approves the application it will establish, as conditions to be met prior to the issuance of a charter, requirements as to (1) minimum number of subscribers to the association's capital; (2) minimum amount of capital to be paid into the association's savings accounts upon issuance of a charter to it; (3) guarantee by the organizers or others of the association's organization and operating expenses; and (4) such other requirements as it deems necessary or desirable. (12 CFR §543.2(d))[2]

The Court of Appeals rested the Board's authority on the catch-all language of subsection (4) "requirements as it deems necessary". Yet the Court ignored the thrust of subsection (3) which specifically limited *any* guarantees to "*organization* and *operating* expenses." In effect, the court gave subsection (4) a sufficiently broad interpretation to render subsection (3) unnecessary.

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[2] This rule has since been amended with the guarantee provision omitted as of May 26, 1965. 12 CFR §543.2(g).

With these considerations in clear focus, the conclusion is inescapable that the Board acted in contravention of its own rules. The only reasonable reading of the applicable rule is to limit the Board in the area of guarantees in spite of the "requirements as it deems necessary or desirable" clause. By any principle of interpretation, can it reasonably be argued that the Board did not intend to limit the practice of requiring guarantees to cover organization and operating expenses? The reason for limitation is obvious. Any wider authority would allow the Board to require a guarantee of any and all losses which might result in any federally chartered association. This would effectively limit control of federal savings and loans only to those wealthy enough to risk such an agreement. Such is not the intent or purpose of the Home Owners Loan Act (12 USC §1464(a)). In addition, the Board could arbitrarily require the organizers to become insurers of the deposit accounts even though Congress has exclusively placed this responsibility with the Federal Savings and Loan Insurance Corporation.

Therefore, the rule will not justify the broad guarantee practice engaged in by the Board in this case. The agreement the Board extracted from the organizers included *any and all future losses* and covered a five-year period. Subsection (3) of the Rule prohibits an interpretation authorizing the extensive guarantee which the Board required in this case. The specific limitations of lawful guarantees to organization and operating expenses renders completely untenable the Court of Appeals holding that the practice can be justified by the "necessary or desirable" language of subsection (4) of the Rule.

Since the Board exceeded its authority the guarantee agreement in this case was invalid *ab initio*. Since it was invalid and illegal, the claim of Respondent Federal

Savings and Loan Insurance Corporation, based on the invalid guarantee agreement is without merit. The Court of Appeals erred in reversing the trial court judgment for petitioners and should have held the "Pledge and Escrow Agreement" invalid. The Court of Appeals should be reversed and the judgment of the trial court affirmed.

**2. The Statutory Duty of the Federal Savings and Loan Insurance Corporation to reimburse any loss of deposits in this case offsets any claim it may have to the $50,000 in controversy.**

This alternative argument is best summed up as follows: The organizers and others deposited $50,000 in First Federal in 1964 pursuant to the "Pledge and Escrow Agreement." The $50,000 was deposited in twelve regular deposit accounts. The deposits were federally insured which insurance was never waived by the depositors. If losses occurred in these accounts, the Federal Savings and Loan Insurance Corporation is liable to each of the depositors. Therefore, any claim it may assert as assignee would be offset by its liability as the insurer of the accounts. Petitioners are entitled to the $50,000.

Some elaboration on this argument will be helpful. The National Housing Act requires Respondent to insure savings share accounts of depositors in a Federal Savings and Loan Association 12 USC §1726(a).

Respondent Insurance Corporation, is, without exception, required to make prompt payment of each insured account in the event of default. The statute provides:

> In the event of a default by any insured institution, payment of each insured account in such insured institution which is surrendered and transferred to the Corporation shall be made by the

> Corporation as soon as possible either (1) by cash or (2) by making available to each insured member a transferred account in a new insured institution in the same community or in another insured institution in an amount equal to the insured account of such insured member: *Provided,* That the Corporation, in its discretion, may require proof of claims to be filed before paying the insured accounts, and that in any case where the Corporation is not satisfied as to the validity of a claim for an insured account, it may require the final determination of a court of competent jurisdiction before paying such claim. 12 USC 1728(b).

Pursuant to statutory duty, *each* account in First Federal was insured by respondent. A search of the record will demonstrate that Petitioners at no time expressed any waiver of these benefits. Indeed, the "Pledge and Escrow Agreement" itself does not contain any language from which a waiver could be even *implied.* (App. 28, 62). Lacking an express waiver, and lacking language from which a waiver of the statutory benefits may be implied, there is only one conclusion that may logically be drawn: the deposits are entitled to insurance.

An additional reason to reject respondent's claim rests on the well-established principle that a statutory right will not be considered waived unless the waiver is clear and unequivocal. No authority exists to find waiver by implication.

A consideration of this argument vividly illustrates the nature of the bizarre agreement which the Board attempted. It was legally an impossibility, *ab initio.* The impossibility rests in the Board's attempt to use $50,000 in deposits that were insured as insurance against future losses. In event of default, the deposits would be lost, giving rise to a claim for insurance from the Insurance Corporation.

The Board's decision to require a guarantee by federally insured deposits indicated poor judgment on its part. If the guarantee had been by funds in a non-insured separate account or institution (a true pledge escrow or guarantee) the question would be different. If the Court of Appeals' decision is allowed to stand, an exception will have been created in the insurance provisions of the National Housing Act only because the Insurance Corporation found itself in the embarrassing position of having a worthless claim based upon an inherently illegal agreement.

The simple conclusion of the Court of Appeals that a pledgor cannot recover insurance on an insured item forfeited under the provisions of a consensual pledge (Appendix, p. 17a, 396 F2d 412) is without any support in authority or reason. A bizarre agreement such as is involved here should not be allowed to create a mischievous exception in a clear statute. The decision of the Court of Appeals must be reversed.

## CONCLUSION

For the foregoing reasons, petitioners respectfully pray that a writ of certiorari be issued to the United States Court of Appeals for the Seventh Circuit.

Petitioners further pray that the judgment and opinion of the Seventh Circuit be reversed and that the judgment of the trial court be affirmed.

Respectfully submitted,

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# APPENDIX

## MEMORANDUM OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS

This matter coming on to be heard on cross motions for summary judgment, and the material facts not being in dispute, the Court hereby makes the following findings of fact and conclusions of law:

(1) First Federal Savings and Loan Association of Morton Grove, Illinois, was chartered on or about August 1, 1959. In connection with the issuance of the Charter by the Federal Home Loan Bank Board to First Federal Savings and Loan Association of Morton Grove (hereinafter called First Federal), the Federal Home Loan Bank Board prescribed a condition that evidence of a valid pledge of share accounts of the Association, in the amount of $50,000, be made as a guaranty to the Association against operation deficits and losses of any and all kinds which exceed other reserves. This was done pursuant to their power under 12 U.S.C. §1464. Accordingly, an agreement was signed by fourteen depositors of First Federal covering $50,000 which these persons had placed in First Federal. The fourteen depositors signed the document entitled, "Pledge and Escrow Agreement", as individuals, although all of the officers of First Federal were from among the original signatories. Five of these depositors were on the organizing committee to establish the Savings and Loan Association.

(2) These fourteen individuals received no money for signing the agreement, but a Charter for First Federal was issued by the Federal Home Loan Bank Board pursuant to the terms of the agreement.

(3) The fourteen depositors agreed to deliver the shares which they had in First Federal "in escrow to the Federal Home Loan Bank of Chicago, to be held by it as

a pledge and guaranty to First Federal Savings and Loan Association of Morton Grove against operating deficits and losses of any and all kinds which exceed other reserves; this pledge and agreement to remain in full force and effect for a period of five years beginning August 1, 1959."

(4) The agreement contains numerous other provisions which are important to the disposition of this case. One of these provisions gives the Federal Home Loan Bank Board power to make a finding that an impairment in the capital of the Association or a deficit exists after the payment of all expenses by the Association and thereby gives the Board authority to direct the Federal Home Loan Bank of Chicago to deliver the accounts pledged, or any portion thereof, to the Association for cancellation and the simultaneous transfer upon its books of the dollar amount of credits represented by the cancelled accounts to the reserves of the Association for the purpose of absorbing losses or operation deficits.

(5) The agreement also contains a provision regarding the equity of redemption of the depositors, whereby the Association agrees to refund any amounts taken from the accounts from and after August 1, 1964, "whenever possible", provided "that no reserves for losses and surplus would thereby be reduced to less than three per cent of its net assets."

6) In addition, the agreement provides twice, in two separate paragraphs, that:

> This pledge and agreement to remain in full force and effect for a period of five years beginning August 1, 1959, provided that after the expiration of the first three years of the term of this agreement, the release of said pledge and escrow, in whole or in part, may be authorized by the Federal Home Loan Bank Board whenever the net reserves established for the purpose of absorbing losses and surplus of the association together equal at least 3% of its net assets.

(7) On February 15, 1962, depositor Edwin Hancock withdrew his funds and the account of John O. Braeseke was substituted in his place. On December 6, 1963, depositor Tony Marino was substituted under the agreement by an account in the names of Ray Giese, Leroy Gunter and Joseph Reiter. The other depositors maintained their accounts intact, and, taken together, the accounts still amounted to $50,000.

(8) The money deposited pursuant to the Pledge and Escrow Agreement was not transferred initially or at any time thereafter to the Federal Home Loan Bank or to the Federal Home Loan Bank Board. The actual money was kept in the First Federal itself so that it could be used by that institution. This presumably was in accord with the purpose of the agreement.

(9) In 1964, First Federal's problems with management and delinquent loans caused it to submit proposals to the Federal Home Loan Bank Board for solutions to these problems, including proposals arranged by the Association itself for possible mergers. A specific plan of merger to solve First Federal's problems was submitted to the Federal Home Loan Bank Board and disapproved by the Board on June 15, 1964.

(10) Although First Federal did not have the passbooks for the accounts, the Board of Directors resolved at a special meeting to return the money from the accounts of the fourteen depositors. The Board of Directors of First Federal, therefore, resolved that this should be done by disbursing checks covering principal and interest in the amount of $55,557.26 to Joseph Reiter and Leroy Gunter, "as co-trustees for the pledgors". The Board of First Federal directed that these funds be held by the two co-trustees for the pledgors pending final determination of the status of the accounts. The resolution also stated that First Federal was taking this action in view of the rejection by the Federal Home Loan Bank Board of proposals which they felt would have represented a practical and final solution to the Association's problems. Thereafter, on June 18 and June

20, 1964, two checks were issued by First Federal Savings and Loan Association of Morton Grove in the amounts of $50,000 and $5,557.26 in the names of Joseph Reiter and Leroy Gunter as co-trustees. Thereafter, said checks were deposited with the Merchandise National Bank of Chicago in the names of Joseph Reiter and Leroy Gunter as co-trustees. After this suit was filed, the funds were transferred to National Boulevard Bank of Chicago, where they are on deposit at the present time. The $5,557.26 represented interest on the $50,000 and is not in dispute in this action.

(11) On January 4, 1966, the defendant presented an order to this Court by agreement with the plaintiffs, stating in part as follows:

> It is further ordered that plaintiffs be and they are hereby authorized to withdraw the balance of $5,557.26 in that deposit account.

This order constituted a waiver of the defendant's interest in the funds withdrawn to the extent of $5,557.26.

(12) On June 23, 1964, the Federal Home Loan Bank Board, by letter, informed the Federal Home Loan Bank of Chicago that an impairment in the capital of First Federal existed and that the Federal Home Loan Bank should deliver the shares pledged under the agreement to the Association "for cancellation with instructions that the dollar amount of credits represented by such shares be simultaneously transferred upon the Association's books to the reserves of the Association for the purpose of absorbing losses." This was done in accordance with the terms of the Pledge and Escrow Agreement. At the time of this finding by the Federal Home Loan Bank Board, there were losses and deficits in excess of $55,557.26.

(13) On June 27, 1964, a conservator for the Federal Home Loan Bank Board took over the Association pursuant to the provisions of the Home Owners Loan Act of 1933, 12 U.S.C. §1464, et seq. First Federal previously had consented to the appointment of a receiver, whenever in the judgment of the Federal Home Loan Bank

Board such action was deemed necessary, by resolution of June 8, 1964. The Federal Home Loan Bank Board, by meeting of June 15, 1964, had resolved that a conservator be appointed as of the close of business June 27, 1964.

(14) On June 27, 1964, the conservator assumed responsibility for the management of the Association and effected a merger between First Federal and Second Federal Savings and Loan Association of Chicago. Under the Plan of Merger and Merger Agreement, it was provided that First Federal of Morton Grove shall be merged with and become part of Second Federal of Chicago, which shall be the resulting association. The existing Charter of Second Federal is made the Charter of the resulting association. The existing Charter of First Federal is cancelled. It is said that the resulting association shall be deemed to be, and shall be, a continuation of the entity and identity of Second Federal. However, no such provision is found as to First Federal. It is also provided that "all liabilities of First Federal . . . shall be assumed by the resulting association and may be enforced against it to the same extent as if such liabilities had been incurred or contracted by it."

(15) On July 16, 1964, Second Federal gave a written assignment to the defendant of its right, title and interest to the claim of Second Federal against Joseph Reiter and Leroy Guntner, co-trustees, to the $55,557.26. By letter, dated August 3, 1964, defendant paid Second Federal $55,557.26 for this assignment. By letter, dated August 28, 1964, to Joseph Reiter, Leroy Guntner, Luke Meier, John Braeseke and Ray Giese, the defendant demanded the return of the sum of $55,557.26, acting as assignee of Second Federal and basing its claim on the rights of Second Federal acquired from First Federal.

(16) On September 5, 1965, Joseph Reiter and Leroy Guntner filed the present suit, as co-trustees for the fourteen depositors under the Pledge and Escrow Agreement, seeking a declaratory judgment that the defendant has no right, title or interest to the funds in question.

In support of their position, the plaintiffs assert a three-pronged argument. First of all, they argue that the Board of Directors of First Federal had the power and authority to return the funds in question to the plaintiffs and no cause of action arose in favor of either First Federal, the Federal Home Loan Bank Board, or Second Federal, as a result of that action. The plaintiffs argue that although the transfer of the funds may have violated the Escrow Agreement, the only possible legal consequence of this violation was the revocation of First Federal's Charter by the Federal Home Loan Bank Board.

The plaintiffs' second argument is based on the order entered by this Court upon stipulation by the parties. This order is found in my Finding of Fact #11. The position of the plaintiffs is that this waiver of rights to the interest on the pledged fund was an admission that the defendant had no interest in the $50,000.

I find the first of these arguments very persuasive. The second is rather weak. The waiver which was entered on the record by stipulation of the parties was done for the convenience of this litigation, and I do not see how it can be considered an admission by the defendant. I consider it irrelevant to the controversy over the $50,000 and have not considered it in my resolution of the controversy.

My position on the two matters set forth above could be stated with somewhat more detail. However, I will not do that in light of the fact that I find the plaintiffs' third argument clearly dispositive of the case. I am in full agreement with the plaintiffs that the duty of the defendant's assignor, Second Federal, to reimburse the plaintiffs is a complete defense against any rights to the funds that the defendant might have.

As was previously set out in my Findings of Fact, part of the Escrow Agreement provided that after August 1, 1964, any amounts taken from the accounts of the pledgors would be refunded "whenever possible" provided "that no reserves for losses and surplus would there-

by be reduced to less than three per cent of" the Association's net assets. It cannot be contested that this right to reimbursement did not exist at the time that First Federal merged with Second Federal. Also, it must be admitted by the plaintiffs that there was no right to reimbursement when Second Federal assigned their rights, if any, to the $50,000 to Second Federal. However, when Second Federal merged with First Federal, it was agreed that:

> • • • all liabilities of First Federal . . . shall be assumed by the resulting association and may be enforced against it to the same extent as if such liabilities had been incurred or contracted by it.

It may be true that at the date of the merger Second Federal obtained as one of the assets of First Federal the right to proceed against the plaintiffs for the $50,000 which the Board of Directors had ordered paid to them. But, this right was conditioned by the terms of the Escrow under which the right arose. The Escrow Agreement contained the stipulation that the money forfeited, the $50,000 in question, would be reimbursed, "whenever possible", as soon after August 1, 1964, as the Association had sufficient assets, so that its reserves for losses and surplus would not be reduced by the payment below per cent of its assets. One cannot look upon the merger agreement as providing anything other than that the above-described proviso of the Escrow Agreement was one of the liabilities which Second Federal assumed.

Accordingly, as the assignee of Second Federal's claim to the $50,000 in this suit, the defendant's rights to the money are limited by the plaintiffs' right to reimbursement. This right to reimbursement matured on August 1, 1964, at which time the financial position of Second Federal was such that they were obliged to pay back to the plaintiffs any money which they may have forfeited. Consequently, if I were to hold that the First Federal had a right to the money which was paid to the plaintiffs, and that this right was transferred to Second Federal under the merger agreement, I would

likewise be obliged to find that the right to reimbursement which matured on August 1, 1964, existed at the time of the merger and stood as an absolute defense to any action by Second Federal, or by their assignee, the defendant, to obtain possession of the funds in question in this suit. The defendant here is an assignee and stands in the shoes of its assignor. As such, any defense by plaintiffs against the assignor is valid as against the assignee.

Since I am convinced that the plaintiffs have an irrefutable defense to any action by the defendant to the money in question, I find that the plaintiffs' motion for summary judgment must be and hereby is granted. The defendant's motion is denied. I declare that the defendant has no claim to the funds held by the plaintiffs as trustees because of an absolute defense which exists in favor of the plaintiffs.

Enter:

James B. Parsons
*United States District Judge*

Date: June 29, 1967

IN THE

# UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

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SEPTEMBER TERM, 1967 — APRIL SESSION, 1968

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No. 16485

JOSEPH REITER and LEROY GUNTNER,
*Plaintiffs-Appellees,*
v.
FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION,
*Defendant-Appellant.*

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

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JUNE 7, 1968

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Before KNOCH, *Senior Circuit Judge,* and SWYGERT and CUMMINGS, *Circuit Judges.*

CUMMINGS, *Circuit Judge.* Plaintiffs sued for a declaratory judgment that the Federal Savings and Loan Insurance Corporation ("Insurance Corporation") has no title to a $50,000 account on deposit in the National Boulevard Bank of Chicago.[1] The Insurance Corporation is a corporate instrumentality and agency of the United States, organized under Subchapter IV of the National Housing Act (12 U.S.C. § 1725 *et seq.*).

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[1] This $50,000 account had been augmented by $5,557.26 in dividends or interest, but only the ownership of the $50,000 originally pledged by the plaintiffs and their associates is at issue.

Plaintiffs were the president and secretary of the First Federal Savings and Loan Association of Morton Grove, Illinois ("First Federal"), which was chartered on August 1, 1959, by the Federal Home Loan Bank ("Loan Bank"), which is an agency of the United States charged with the responsibility of chartering, regulating and insuring federal savings and loan associations. It manages and supervises the Insurance Corporation. As a condition for the issuance of First Federal's charter and for the insurance of its accounts by the Insurance Corporation, the Loan Bank exacted a pledge of First Federal savings share accounts in the sum of $50,000 as a guarantee by the pledgors to First Federal against losses. Accordingly, 12 share accounts were pledged to the Federal Home Loan Bank in Chicago. Eight of these accounts were of organizers, directors and officers of First Federal. Plaintiffs were among the pledgors and are suing for themselves and the other remaining pledgors.

In September 1960, the pledgors executed a Pledge and Escrow Agreement effective August 1, 1959, the date of the issuance of First Federal's charter. The pledgors assigned and delivered their $50,000 First Federal shares in escrow to the Federal Home Loan Bank of Chicago for five years. In pertinent part the Merger and Escrow Agreement provided that whenever the Loan Bank should find any impairment in First Federal's capital, it would direct the Federal Home Loan Bank of Chicago to deliver the pledged shares to First Federal for cancellation and transfer upon its books of the dollar amount of credits represented by the cancelled shares to the reserves of First Federal for the purpose of absorbing its losses or operating deficits. The Pledge and Escrow Agreement contained the following refund clause upon which plaintiffs rely:

> "If during the life of this agreement there shall have been any charges against the share accounts herein pledged, the said association shall, whenever possible after the termination of this agreement, refund such amounts on a pro rata basis to the pledgors; provided, however, that no refund to any

pledgor shall exceed the amount such pledgor has been required to forfeit by reason of the terms of this agreement; and provided, further, that no such refund shall be made when the said association's net reserves for losses and surplus would thereby be reduced to less than 3% of its net assets."

The Pledge and Escrow Agreement also provided that the pledged shares were to be delivered by the Federal Home Loan Bank of Chicago to First Federal for like cancellation and transfer in the event of First Federal's liquidation.

In May 1964, plaintiffs and other directors of First Federal advised the Federal Home Loan Bank of Chicago as follows:

"The audit of the Association reveals that the Association will be minus $47,000.00 in meeting its June 30, 1964 dividend of 4¼%. The survey of delinquencies reveals a potential loss of $174,000.00 upon bad loans (see attached). Reserves at present are at $72,000.00."

On June 8, 1964, the First Federal directors adopted a resolution consenting to the appointment of a conservator.

On June 15th, the Loan Bank rejected alternative proposals submitted by First Federal with respect to its future operations and appointed Clarence M. Christie as its conservator, effective June 27, 1964, on grounds of its insolvency, violation of law or regulation, and unsafe or unsound operation.

On June 18th, First Federal's directors adopted another resolution, acknowledging that the Loan Bank had expressed its intention to levy against the $50,000 pledged saving share accounts and authorizing plaintiffs to withdraw $50,000 as co-trustees for the pledgors, to hold said amount in escrow "pending final determination of the status of the accounts." On the same date, plaintiff Reiter drew a First Federal $50,000 check payable from the general funds of the Association on deposit at the LaSalle National Bank of Chicago, payable to the plaintiffs as

co-trustees. The proceeds of the check were ultimately deposited in their trust account at the National Boulevard Bank of Chicago. No charge was made against the individual pledged share accounts; no change was made in the ledger accounts or cards representing those accounts; and the passbooks remained in the possession of the Federal Home Loan Bank of Chicago. The $50,000 trust account was shown on First Federal's books as an asset under "Accounts Receivable" and later under "Account in Escrow."

On June 23, 1964, the Loan Bank wrote the Federal Home Loan Bank in Chicago that there was an impairment in the capital of First Federal. Accordingly, the Federal Home Loan Bank of Chicago was directed to deliver the $50,000 pledged share accounts to First Federal for cancellation, with instructions that the dollar amount of the credits represented by the pledged shares be transferred upon First Federal's books to its reserves for the purpose of absorbing losses. The conservator took charge of First Federal on June 27, 1964, and thereupon carried out the cancellation and transfer instructions. After reflecting the $50,000 charge in the pledged passbooks, he returned them to the pledgors on the same date.

Also on June 27, the conservator entered into a Sale and Purchase Agreement with the Insurance Corporation. In order to prevent a default by First Federal, the Insurance Corporation agreed to purchase certain First Federal assets, thus facilitating a merger between First Federal and the successful Second Federal Savings and Loan Association of Chicago ("Second Federal"). Pursuant to this agreement, the Insurance Corporation paid $2,800,000 for various distressed and doubtful assets of First Federal and assumed all its undisclosed liabilities. The agreement was to terminate unless First Federal and Second Federal should merge within 30 days therefrom.

Again on June 27, First Federal's conservator entered into a Plan of Merger and Merger Agreement with

Second Federal, which was to become the resulting association. Second Federal's charter was made the charter of the resulting association, and First Federal's charter was surrendered for cancellation. The Merger Agreement provided that the resulting association was to be a continuation of Second Federal. All First Federal's assets, including those arising under the Sale and Purchase Agreement between First Federal and the Insurance Corporation, were vested in Second Federal, and all First Federal's saving share accounts were transferred to Second Federal. The Merger Agreement also provided that the resulting association would assume all liabilities of First Federal.

On June 16, 1964, Second Federal assigned to the Insurance Corporation all of Second Federal's rights in the $50,000 in dispute. In return, the Insurance Corporation paid Second Federal $50,000.

A payment of $50,000, the amount of the pledged share accounts, by Second Federal to plaintiffs would not reduce its net reserves to less than 3% of its net assets, and the District Court held that under the above-quoted refund clause of the Pledge and Escrow Agreement, Second Federal was obligated to refund that amount to plaintiffs. The Court held that this obligation passed to the Insurance Corporation and that it was accordingly without any interest in the $50,000 on deposit at the National Boulevard Bank of Chicago. Summary judgment was entered for plaintiffs.

By way of dictum, the District Court found "very persuasive" an argument of the plaintiffs that although the June 1964 transfer of these funds to them may have violated the Pledge and Escrow Agreement, the only legal consequence would be the revocation of First Federal's charter. However, the summary judgment for plaintiffs was entered on an alternative ground. Thus the Court held the aforesaid refund clause of the Pledge and Escrow Agreement was applicable, stating "I am in full agreement with the plaintiffs that the duty of the defendant's assignor, Second Federal, to reimburse the

plaintiff [under that clause] is a complete defense against any rights to the funds that the defendant might have."

We cannot agree with either ground and therefore reverse.

On June 8, 1964, First Federal's directors consented to the appointment of a conservator. Ten days later, knowing of First Federal's desperate position, five of its directors, having previously pledged their First Federal share accounts to the Federal Home Loan Bank of Chicago, voted to disburse the funds represented by all the pledged accounts to plaintiffs as co-trustees. On the same day, plaintiffs withdrew $50,000 from the First Federal's general checking account at the LaSalle National Bank and deposited it in another bank, and later at the National Boulevard Bank of Chicago. Plaintiffs were of course not entitled to withdraw general funds of First Federal for their own benefit. No change was made in the First Federal's ledger account or cards representing the pledged share accounts, the passbooks remained in the hands of the Federal Home Loan Bank of Chicago, and First Federal continued to show the withdrawn sum as an asset. Therefore it would appear that the withdrawal was from its general funds.[2] First Federal had the right to those funds. This right passed to Second Federal under the Merger Agreement and in turn to the Insurance Corporation by assignment. Therefore, plaintiffs have no interest in the funds unless they acquired a right of reimbursement under the refund clause of the Pledge and Escrow Agreement.

Under the impairment in capital clause in the Pledge and Escrow Agreement, the Loan Bank directed the

[2] If the withdrawal was from the pledged share accounts as plaintiffs contend, it was still illegal, for only the Loan Bank could release these accounts from the terms of the Pledge and Escrow Agreement, and it did not do so. Instead, the Loan Bank caused this amount to be transferred to First Federal's reserves. This asset passed to Second Federal upon the merger with First Federal and was later assigned to Insurance Corporation.

pledgee Federal Home Loan Bank of Chicago to deliver the pledged shares to First Federal for cancellation, with the amount of credits represented by these shares transferred to reserves on First Federal books. This was done by First Federal's conservator on June 27, 1964, when he charged the pledged accounts in the amounts pledged, thereafter returning the passbooks to the pledgors.

The refund clause in question required First Federal to refund the pledged amounts to the pledgors "whenever possible" after the August 1, 1964, termination of the Pledge and Escrow Agreement, provided that no refund should be made when First Federal's net reserves would be reduced to less than 3% of its net assets.

Concededly, the refund of these pledged accounts would have reduced First Federal's net reserves to less than 3% of its net assets. If First Federal's operations eventually had resulted in the accumulation of adequate reserves, the refund clause would clearly have applied to plaintiffs and the other pledgors. But it is plain that the refund clause was conditioned on First Federal's acquisition by its own devices of adequate capital reserves and not to this situation where the Insurance Corporation had to purchase $2,800,000 of doubtful assets of First Federal and to assume all its undisclosed liabilities. It was only this intervention of the Insurance Corporation that made possible the "merger" of First Federal into Second Federal. Under the Merger Agreement the new association was expressly "a continuation of the entity and identity of Second Federal" and the charter of First Federal was cancelled. There was no longer a First Federal as contemplated by the refund clause in question. In our view, the refund clause was not meant to apply after the failure of First Federal but required the continuation of business on its part. Cf. *International Co. of St. Louis* v. *Sloan*, 114 F.2d 326, 329 (10th Cir. 1940, certiorari denied, 311 U.S. 702). It is true that under the Merger Agreement Second Federal assumed the pre-existing liabilities of First Federal. However, First Federal

was not under any obligation to refund the $50,000, for its reserves would thereby have been reduced to less than 3% of its net assets. Consequently, Second Federal's assumption of First Federal's liabilities did not require Second Federal to refund the $50,000 to plaintiffs and the other pledgors.

Looking at substance, First Federal had failed and was in effect liquidated. Plaintiffs can point to no clause in the Pledge and Escrow Agreement that would entitle them to a refund in the event of liquidation.[3] The refund clause in question would not apply by its very terms, for First Federal was no longer *in esse* in any form.

Our conclusion that the refund clause is inapplicable is consistent with the purpose of the Pledge and Escrow Agreement. To induce the insuring of First Federal's accounts and the issuance of a charter, these pledges were required to provide a cushion against First Federal's failure and to encourage First Federal's organizers to work for its success. As a result of that failure, defendant was forced to advance $2,800,000 to persuade Second Federal to take over First Federal's insured deposit share accounts. Even the small cushion provided by the pledges would be lost if the refund clause were held to apply. Of course, the additional purpose of the cushion to encourage the best efforts of First Federal's organizers was inapplicable after Second Federal took over.

In sum, we hold only that the refund clause does not cover the circumstances of this case. Mergers are not mentioned in the Pledge and Escrow Agreement, and we

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[3] Defendant did not urge below that First Federal had been liquidated. Nevertheless, it did assert that the refund clause was only operative if First Federal remained in existence and improved its financial position. There is no need to remand for consideration of the liquidation point, for this Court can appropriately construe the Pledge and Escrow Agreement. *United States* v. *General Motors*, 384 U.S. 127, 141, note 16; *Best Medium Co.* v. *National Insider, Inc.*, 385 F.2d 384, 386 (7th Cir. 1967).

need express no opinion whether the refund clause would apply to mergers of viable associations.

Plaintiffs finally argue that their pledges were invalid as beyond the authority of the Loan Bank, Section 1726(b) of the National Housing Act (12 U.S.C. § 1726 (b)) requires insured institutions to provide adequate reserves. Consistently therewith, the regulations, which are a permissible exercise of the power conferred on the Loan Bank by Section 5(a) of the Home Owners' Loan Act (12 U.S.C. § 1464(a)), permit the Loan Bank to prescribe whatever "requirements as it deems necessary or desirable" (12 C.F.R. § 543.2(d)). These provisions empowered the Loan Bank to exact the $50,000 pledged as a guaranty against losses. The fact that insured share accounts were pledged does not bar defendant's claim. A pledgor cannot recover insurance on an insured item forfeited under the provisions of a consensual pledge. Other points raisesd by plaintiffs have been considered but are not persuasive.

The judgment is reversed, with direction to award defendant the deposit in controversy.

A true Copy:

Teste:

.....

*Clerk of the United States Court of Appeals for the Seventh Circuit.*

## JUDGMENT OF UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT (ENTERED: June 7, 1968)

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, Reversed, and that this cause be, and it is hereby Remanded to the said District Court with direction to award defendant the deposit in controversy, in accordance with the opinion of this Court filed this day.

## ORDER DENYING PETITION FOR REHEARING (ENTERED: July 2, 1968)

It Is Ordered by the Court that the petition for rehearing filed in the above entitled cause be and the same is hereby denied.

## STATUTES AND REGULATION

12 U.S.C. § 1464

(a) In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as "Federal Savings and Loan Associations," and to issue charters therefor, giving primary consideration to the best practices of local mutual thrift and home-financing institutions in the United States.

12 U.S.C. § 1726

(a) It shall be the duty of the Corporation to insure the accounts of all Federal savings and loan associations, and it may insure the accounts of building and loan, savings and loan, and homestead associations and cooperative banks organized and operated according to the laws of the State, District, Territory, or possession in which they are chartered or organized.

12 U.S.C. § 1728

(b) In the event of a default by any insured institution, payment of each insured account in such insured institution which is surrendered and transferred to the Corporation shall be made by the Corporation as soon as possible either (1) by cash or

(2) by making available to each insured member a transferred account in a new insured institution in the same community or in another insured institution in an amount equal to the insured account of such insured member: *Provided,* That the Corporation, in its discretion, may require proof of claims to be filed before paying the insured accounts, and that in any case where the Corporation is not satisfied as to the validity of a claim for an insured account, it may require the final determination of a court of competent jurisdiction before paying such claim.

12 C.F.R. § 543.2(d)

"If the Board approves the application it will establish, as conditions to be met prior to the issuance of a charter, requirements as to (1) minimum number of subscribers to the association's capital; (2) minimum amount of capital to be paid into the association's savings accounts upon issuance of a charter to it; (3) guarantee by the organizers or others of the association's organization and operating expenses; and (4) such other requirements as it deems necessary or desirable. (12 CFR § 543.2(d) Rules and Regulations of the Federal Savings and Loan System.

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No. 536

# In the Supreme Court of the United States

OCTOBER TERM, 1968

JOSEPH REITER AND LEROY GUNTNER, CO-TRUSTEES,
PETITIONERS

*v.*

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

ERWIN N. GRISWOLD,
*Solicitor General,*
EDWIN L. WEISL, JR.,
*Assistant Attorney General,*
JOHN C. ELDRIDGE,
*Attorney,*
*Department of Justice,*
*Washington, D.C. 20530.*

# In the Supreme Court of the United States

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

### OPINIONS BELOW

The opinion of the district court (Pet. App. 1a–8a) is unreported. The opinion of the court of appeals (Pet. App. 9a–19a) is reported at 396 F. 2d 407.

### JURISDICTION

The judgment of the court of appeals was entered on June 7, 1968. A petition for rehearing was denied on July 2, 1968. The petition for a writ of certiorari was filed on September 18, 1968. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).



325-301—68

## QUESTION PRESENTED

Whether the Federal Home Loan Bank Board had authority to require and enforce a "Pledge and Escrow Agreement" covering petitioners' insured savings accounts.

## STATEMENT

The First Federal Savings and Loan Association of Morton Grove, Illinois (First Federal), was chartered on August 1, 1959, by the Federal Home Loan Bank Board (Board), an agency of the United States charged with the responsibility of chartering, regulating, and supervising federal savings and loan associations (App. 12; 12 U.S.C. 1464).[1] The Board manages and supervises respondent Federal Savings and Loan Insurance Corporation (FSLIC).

As a condition for the issuance of a charter and for the insurance of the accounts of First Federal, the Board required the execution of a "Pledge and Escrow" agreement by the promoters and organizers of First Federal and several of their business associates covering savings deposits in the aggregate amount of $50,000 (App. 27, 32, 62, 65–67).[2] The savings share accounts were to be held in escrow by the Federal Home Loan Bank in Chicago as a pledge and guarantee to First Federal against losses. The agreement provided that whenever the Board found an impairment in the capital of First Federal or any deficit in any accounting period, the Board might direct the

[1] "App." refers to appellant's appendix in the court of appeals.

[2] Seven of the pledgors, including petitioners, became directors and officers of First Federal.

Chicago Home Loan Bank to deliver the pledged share accounts to First Federal for cancellation and for transfer of the deposits to First Federal's reserves for the purpose of absorbing losses (App. 64).[3] It further provided that if any charges against the pledged share accounts had been made, First Federal was to refund such amounts, whenever possible after the termination of the Agreement on August 1, 1964, provided such refund would not reduce the net reserves of First Federal to less than three per cent of its net assets.

In May 1964, the directors of First Federal advised the Board that First Federal had suffered a deficit in its current accounting period and that it anticipated sizeable future losses (App. 68).[4] On June 8, 1964, the directors consented to the appointment of a conservator, and on June 15, the Board appointed a conservator to take charge of First Federal on June 27.

In anticipation of the Board's enforcement of the Pledge Agreement, the directors of First Federal, on June 18, authorized petitioners Reiter and Guntner (president and secretary, respectively, of First Fed-

[3] The agreement also provided that the pledged share accounts might also be delivered for cancellation and transfer for the purpose of absorbing losses in the event of First Federal's liquidation.

[4] The directors admitted that First Federal would be deficient $47,000.00 of the amount necessary to pay a current dividend on savings accounts (App. 68). They also conceded potential losses of $174,000.00 on bad loans as against reserves of only $72,000.00. They sought the Board's permission to use escrow funds to meet current dividend requirements and offered to replace such escrow funds with sufficient further money to meet one-half of the potential losses.

eral) to withdraw the funds represented by the pledged accounts and to hold the funds as co-trustees for the pledgors (App. 32). Although the passbooks for the pledged accounts were still held by the Chicago Loan Bank, petitioners drew a check for $50,000 on the general funds of First Federal, and the money ultimately was deposited in their trustee account in the National Boulevard Bank (App. 32–33, 81; Pet. App. 11a–12a, 14a).

On June 22, the Board, pursuant to the Pledge Agreement, directed the Chicago Loan Bank to deliver the pledged share accounts to First Federal for cancellation and for transfer of the deposits to its reserves (App. 33, 34). The conservator carried out the cancellation and transfer instructions when he took charge of First Federal.

On June 27, when the conservator took charge of First Federal, he entered into a merger agreement with Second Federal Savings and Loan Association (Second Federal), a successful institution which was to be the surviving association (App. 36–40). In order to facilitate the merger, respondent FSLIC agreed to purchase, for $2,800,000, various distressed and doubtful assets of First Federal and to assume all its undisclosed liabilities (App. 41–46, 81); this agreement was incorporated by reference in the merger agreement (App. 39). All other assets of First Federal, including its rights in the funds withdrawn by petitioners under the Pledge Agreement, were transferred to Second Federal (App. 38–39). Second Federal thereafter assigned, for full consideration, all of its rights in the funds to respondent FSLIC (App. 47). Upon re-

spondent's demand for return of the money, petitioners initiated the present action for a declaratory judgment of their right to retain the funds (App. 2–5).

The district court, construing the terms of the Pledge Agreement, held that petitioners had a right to retain the $50,000 which they had withdrawn from First Federal (Pet. App. 1a–8a). The court reasoned that since a refund of $50,000 would not reduce the net reserves of Second Federal below three percent of its net assets, Second Federal—and therefore its assignee, respondent FSLIC—could not recover the $50,000 because it was obligated under the Pledge Agreement (as the successor to First Federal) to refund that amount to petitioners.

The court of appeals, however, rejected the district court's reasoning and held that Second Federal's ability to make a refund did not entitle petitioners to retain the $50,000 which they had illegally withdrawn from First Federal because petitioners had no right to a refund from Second Federal (Pet. App. 15a–16a). The court held that petitioners' rights under the refund clause in the Agreement were conditioned on First Federal's acquisition by its own operations of adequate capital reserves, which it failed to do, and that petitioners obtained no greater rights where First Federal was merged into Second Federal in order to prevent default and where the respondent had to purchase $2,800,000 of doubtful assets of First Federal. As the court of appeals observed (Pet. App. 15a):

> There was no longer a First Federal as contemplated by the refund clause in question. In our view, the refund clause was not meant to

> apply after the failure of First Federal but required the continuation of business on its part. Cf. International Co. of St. Louis v. Sloan, 114 F. 2d 326, 329 (C.A. 10, certiorari denied, 311 U.S. 702) * * *.

The court of appeals also rejected petitioners' argument that the pledge of share accounts as a condition of the grant of a charter was beyond the authority of the Bank Board (Pet. App. 17a).

## ARGUMENT

In this Court, petitioners do not raise, as they did below, any issue concerning the interpretation of the Pledge and Escrow Agreement.[5] Rather, they argue that the Board had no authority to require petitioners to enter into the agreement as a condition of the issuance of a charter and that respondent FSLIC's attempt to recover the $50,000 is inconsistent with its statutory duty to insure the pledged share accounts.

1. Section 5(e) of the Home Owners' Loan Act, 12 U.S.C. 1464(e), provides that no charter shall be granted unless there is a reasonable probability of an association's success. Section 403 of the National Housing Act, 12 U.S.C. 1726, requires the Federal Savings and Loan Insurance Corporation to obtain an agreement from an insured association to provide and maintain "adequate reserves satisfactory to the Corporation" (12 U.S.C. 1726(b)). By the Pledge and Escrow

[5] The form of the "Pledge and Escrow Agreement" has been modified substantially since this case arose to include a provision covering supervisory merger, bulk sale of assets and other measures used by the Federal Savings and Loan Insurance Corporation to prevent defaults.

Agreement, petitioners—who were First Federal's promoters, organizers, managers, and their business associates—provided a guarantee of "equity" capital to absorb losses until the association's earnings were sufficient to accumulate the "adequate reserves" required by Section 403 of the Housing Act.

In view of the Board's statutory duty to require that a federally insured association have a reasonable probability of success, that it not have an impairment of capital, and that it maintain adequate reserves, the Board had the authority to require the Pledge Agreement. The pledge of petitioners' share accounts was an appropriate and recognized method of assuring the solvency of the association during its initial years[*] and was within the broad discretion which the Board has with respect to the issuance of charters. See *Federal Home Loan Bank Board* v. *Rowe,* 284 F. 2d 274 (C.A.D.C.).

Petitioners also contend that former Rule 543.2(d)(3) of the Board's Rules (Pet. App. 20a) limited guarantees imposed as conditions by the Board to "organization and operating expenses." The court of appeals correctly held, however, that the condition of a guarantee against losses during the association's growth period was authorized by subsection (4) of the same Rule, which permits the Board to establish "such other requirements as it deems necessary or desirable" (Pet. App. 17a, 20a). The limitation in subsection

[*] Petitioners themselves also recognized this fact and, in their letter of May 4, 1964, making certain recommendations about the association, they offered to pledge an additional $50,000 (App. 70).

(3) does not preclude the requirement of such a guarantee which the Board "deems necessary or desirable" under the circumstances to ensure against the insolvency of the association.[7]

2. Petitioners also contend that the "Statutory Duty of the Federal Savings and Loan Insurance Corporation to reimburse any loss of deposits in this case offsets any claim it may have to the $50,000 in controversy" (Pet. 16). But the Federal Savings and Loan Insurance Corporation is obligated by statute to make payment on an insured account only "in the event of a default by any insured institution" (12 U.S.C. 1728). The fact is that there never was a default in the payment of these accounts.

The share accounts were pledged by petitioners to First Federal as a guarantee against the association's deficits or an impairment of its capital (App. 64). Once the condition of the guarantee took effect (*i.e.*, a deficit or impairment of capital) the share accounts were cancelled "and the dollar amounts of credits represented by such cancelled shares" were transferred to First Federal's reserves. The fact that those accounts were federally insured has no bearing at all

[7] Other Rules of the Board recognize that the pledge of share accounts is often a desirable means to assure financial stability. Rules 556.2(g)(4) and 571.5(g)(4), which outline a policy to be followed by the Board in its actions relating to mergers of savings and loan associations, suggests the following possible alternatives to a proposed merger:

> Providing a larger cushion for operating deficits or losses through a pledge of savings accounts by directors and other members of a mutual institution or a contribution to paid-in surplus by stockholders of a permanent stock institution.

on First Federal's rights in the accounts under the Pledge Agreement. First Federal was not obligated to pay an account cancelled under the Pledge Agreement. It follows that since First Federal was not obligated to pay the cancelled accounts, it could not possibly be in default of payment. Hence, respondent FSLIC was not required to pay an insurance claim on the accounts because such a claim never arose.[8]

## CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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NOVEMBER 1968.

[8] Petitioners apparently argue that it is impossible for a savings and loan association to have security interests in its own savings accounts (Pet. 17). It is common practice, however, for banks and savings and loan associations to loan money to borrowers on the security of a borrower's savings account with the loaning bank. In fact, the Home Owners' Loan Act, 12 U.S.C. 1464(c), expressly authorizes this practice.

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